RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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December 27, 1984 **LETTER 903**

Dec. 13, DJIA 1175.91; PTI 1592; A–D Ratio –20.88
Dec. 20, DJIA 1203.29; PTI 1598; A–D Ratio –20.30

THE MARKET: All the world loves excitement, and on December 18 the NYSE gave it to them. To the tune of 170 million shares and a 34 point rise in the Dow, Wall Street bubbled over. The D-J Transports (see chart below) closed above its October peak while the D-J Utility Average also advanced to a new high for the year (actually, Utilities closed at their highest level since 1966).

What happened and why? On the surface, Fed easing of interest rates was credited for the move. Maybe so, maybe not. What we do know (see last Letter)is that earlier the Transports had refused to confirm the weakness of the Industrial Average. When the Industrials closed at 1163.21 on December 7 the Transports were far above their comparable lows.

We also know (last Letter, page 2) that the short-term trading index was down on 14 out of 17 trading days leading to December 3. Thus, we had a very over-sold market, an important downside non-confirmation by Transports, a Utility Average at an 18 year high, a strong bond market, and an advance-decline ratio which failed by a fraction to break below its preceding low (even as the Dow sank to new lows).

The result was the December 18 explosion. I noted three unusual things about the December 18 rise. First, it came on 170 million shares, sixth biggest day in Exchange history. Second, all thirty of the Dow Industrial stocks were up. That kind of action (all thirty stocks simultaneously up on huge volume) is often climactic. The third item is that the Transports closed at a new high (see page 1 chart), but the Industrials refused to confirm. So the verdict is still out on the secondary and even the primary trend of this market!

I have been writing in recent Letters that the D-J Averages are currrently in "a line" formation. A line is essentially an indecision pattern, a sideways formation in which the forces of accumulation and distribution are very evenly matched. For a valid prediction of the trend, BOTH Averages must break out either above the line limits or below the line limits. This simply has not happened so far.

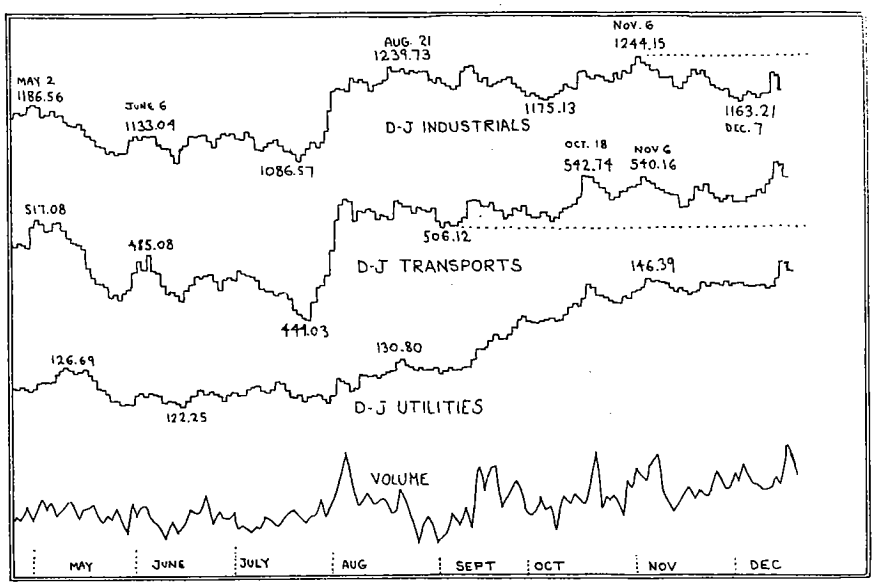
I view the new Transport high as an extension of the line limits. At this point for a breakout of the line on the upside to occur, the Industrials would have to better their November 6 high of 1244.15. For a valid line breakout on the downside, I would want to see Industrials break below 1163.21 confirmed with a Transport drop below 506.12.

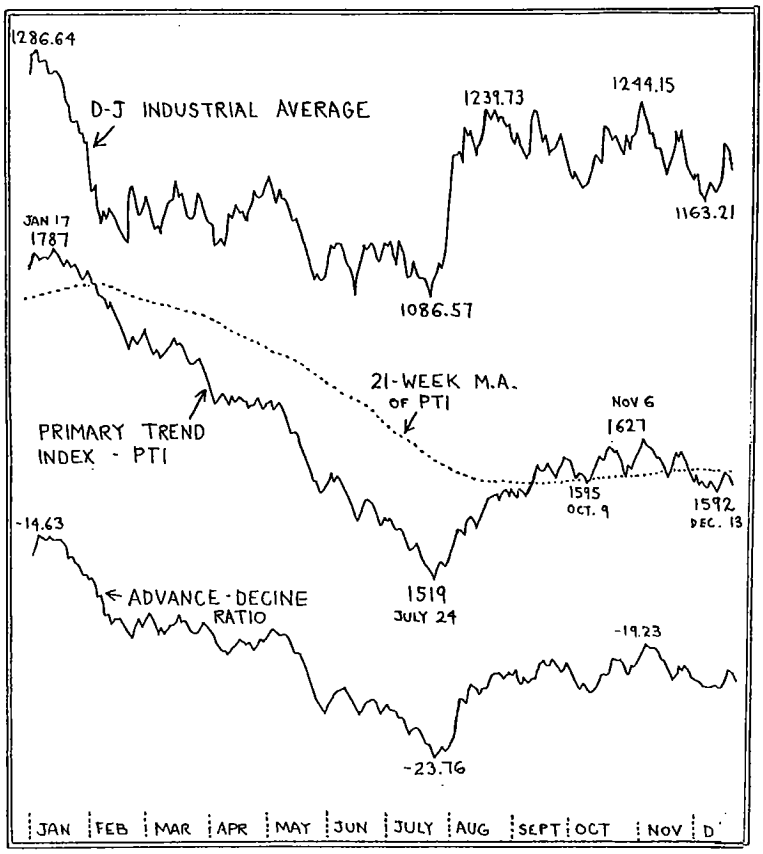
The line formation has been in force for almost five months. And it's becoming tedious. Frankly, I wish I could hurry the decision of the market, but as I've said so many times, they don't run Wall Street for the benefit of Richard Russell and his subscribers. Patience is needed here. The market will tell its story in its own good time.

Turning to the page 2 chart we see that the advance-decline ratio (which is a proxy for the whole market) was strong enough to hold above its October low but not strong enough to better its 119.23 November high. Thus, I rate the near-term breadth picture as neutral.

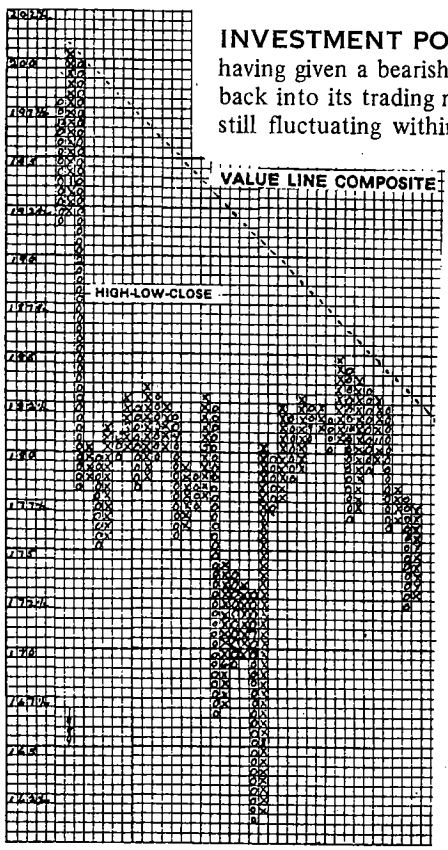
As for my Primary Trend Index, this is an indicator which daily measures the build-up or decline in market technical strength. The PTI is based on eight action-of-the-market indices (rather than on sentiment indices). On December 19, following its fall to a new low of 1592 (December 13), the PTI pushed back to the vicinity of its 21-week moving average. In the last Letter I stated that I was neutral-bearish on the PTI, I'll change that to simply neutral now. However, because the PTI did make a new four month low on December 13, I have to remain cautious. The fact is that the PTI has been walking the 21-week moving average tightrope ever since early September, a period of almost four months. In doing so, the PTI has really told its story. The story is – stubborn indecision.

I have been using the broad Value Line Composite (comprising over 1600 stocks) to provide readers with a picture of what "the average stock" is doing. On the page 2 point and figure chart we see the VLC forming a huge potential head-and-shoulders bottom. But then things changed. Over the last month the right shoulder





broke down and with it the pattern turned bearish. The first encouraging sign here would be a rise in the VLC to 179 (the VLC is quoted daily in the Wall Street Journal and many local newspapers).



INVESTMENT POSITION: The PTI, having given a bearish signal, has now rallied back into its trading range. The Averages are still fluctuating within the confines of their "Line." For this reason, I have a blank box this report – no bull and no bear. If there is a definite trend in this market, my indices don't see it, and neither do the Averages.

I'm still not hot about stocks and I continue to feel that the bonds we bought earlier represent the biggest bargain around. Municipal bonds (AA quality) now yield about 9.5% and they are free of taxes. Against this, T-bills (91-days) yield less than 8% and are taxable by the Feds. The muni bonds have been depressed by over-supply and scared by the specter of the new "flat tax" bill. They still look cheap to me (but only if you're in a tax bracket of 40% or more).

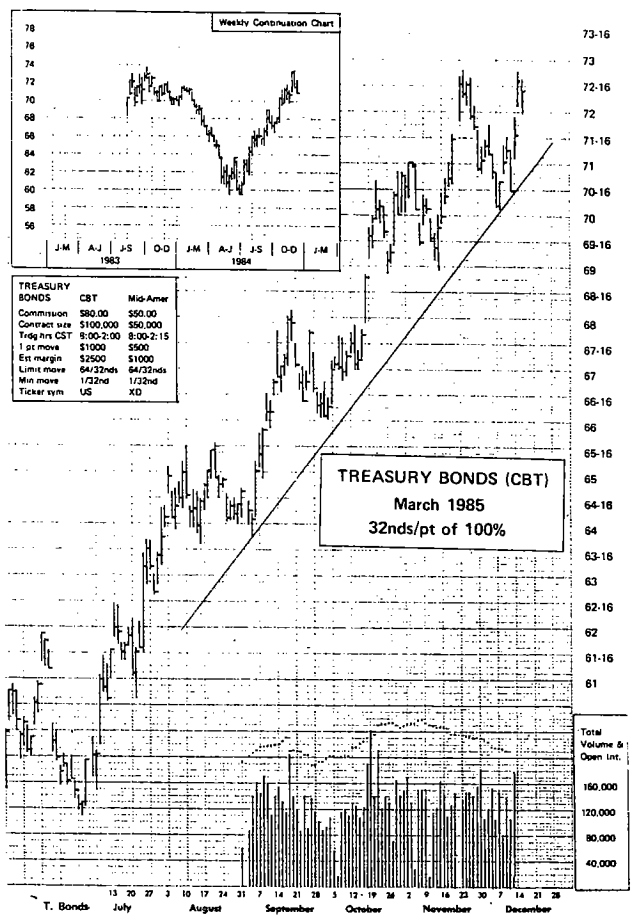
Gold continues to be an investment disaster – which should hardly come as a surprise to my readers.

STOCKS: In studying the thirty Dow Industrial shares, I usually look for two technical items: (1) is the stock acting better than the general market? and (2) is the stock fluctuating above its own moving average? On this basis, there are remarkably few Dow stocks that definitely fit those two criteria. They are Allied Corp, Amer. Brands, Amer. Can, Gen Foods (but barely), Int. Harvester (barely), IBM, although IBM stock could be double-topping in the 122-125 area. And that's that.

RATES, BONDS: Here's a picture we've followed for many months. It's a chart of the Treasury bonds (March contract, chart by Dunn & Hargitt), I turned bullish on the bonds back in the Letter of June 13, and I've been bullish on them ever since.

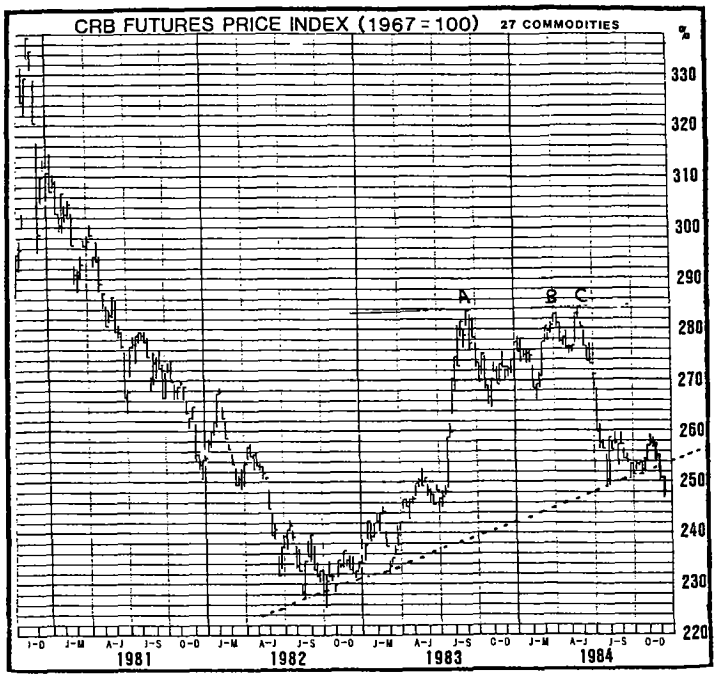
Around November (after a huge move) I said that I thought the bonds could be forming a top. But my advice was to "stay with 'em" until or unless they cracked that perfect rising trendline. So far, the trendline has held – perfectly.

There is really no sense in trying to outguess the bond market at this point. I can give you ten reasons why bonds should top-out here, and I can give you just as many reasons why bonds could keep rising. We've got fat profits in the bonds, so why engage in fantasy-scenarios. Let me put it this way: if the March T-bond contract drops below 70½ that's a big caution



signal. If the March contract drops below 70, you've seen a reversal to the downside. Otherwise,sit tight. The bond play has been the best investment/speculation of 1984.

COMMODITY CRACK: Here's a chart that I publish periodically. It's the CRB Commodity Index (27 commodities including silver but not including gold). The chart is particularly significant at this time, because it has cracked its 1982-84 trendline – and it looks very bearish.



Note that the index (at point A,B,C) tried to recover half of its 1980-82 losses, but the advance failed on all three occasions. Now the Index has broken below the halfway level of the 1982-84 rise. As I see it, the CRB Index is telling us the same things that the gold slide has told us – the situation in commodities, in agriculture, on the farm and in the whole raw goods sector from oil to copper, from wheat to platinum – is deflationary.

MORE MARKET COMMENTS: Perhaps the most widely quoted technical statistic around is the number of investment advisors who are bullish. This is a statistic that is compiled weekly by Investors Intelligence of Larchmont, NY. The theory is simply a version of contrary opinion. Advisors (like the public) tend to be trend followers. So when too many advisors start thinking the same way, the odds are that the market has already discounted that view.

Why are the advisors used in this study? Mainly because advisors put their opinions down on paper periodically, and thus it is fairly easy to tabulate what investment advisors or letter-writers are thinking at any given time.

The majority of advisors turned bullish last August following the short-lived upward explosion in the stock market. And they have stayed bullish ever since. For instance, on October 26 with the Dow at 1225, 52% of the advisors tabulated by Chartcraft were bullish and 23% were bearish. On December 7 with the Dow lower, 55% of the advisors were bullish and 28% were bearish. Two weeks ago the bulls jumped (incredibly) to a six year high of 59.8% (!) while the bears dropped to 25.2%. This is not a good reading – too many bulls.

As I have stated, the bullish/bearish advisors study has gathered a wide body of followers. It has also given rise to an opinion that is shared by a large number of advisors. The opinion runs something like this:

(I quote here from Robert Farrell's excellent Merrill Lynch research comment), "Technically, we view the market to be in a long cyclical corrective process between the 1982-83 major upleg of the secular bull market and the next one which we expect to start in the first or no later than the second quarter of 1985. A corrective process rekindles technical strength by converting the bullish enthusiasm of the last bull leg top (mid 1983) to a bearish disinterest."

Farrell then goes on to say that so far the main switch to disenchantment has occurred only among individuals. He states that the institutions are still in the market, and he opines that the institutions seem to think that the next year will be better, that the Fed will ease credit and that the dollar will weaken (therefore helping US exports). All well and good.

I'd rather not embrace any scenario at this juncture. I know that majority opinion is that this is merely the correction between two major upward legs or waves in a major bull market. I know that the "informed opinion" has it that all we need is a little further consolidation or decline, and all those bulls will finally turn bearish, thus laying the groundwork for a good 1985.

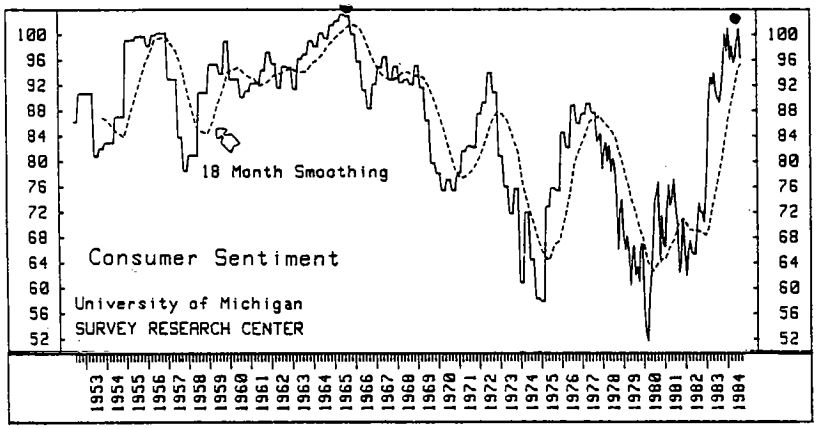
And it may happen just that way, I really don't know. I will say that I am impressed (so far) by the Transportation Average's refusal to break below its September 5 low of 506.12. And I am impressed by the Utility Average's strong performance in the face of the sagging major composites such as the Value Line.

As far as the fundamentals are concerned, the manipulative politics of Washington and the confused statistics out of the Office of Management and Budget make it just about impossible to figure out which way this nation is going. Some of the brightest lights in the world of economics are now at opposing poles. In the last Letter I quoted the Levys on their prediction of a crushing drop in corporate profits during the first half of 1985, along with a recession of undetermined severity. Now along comes Dr. Henry Kaufman of Salomon Bros. with a totally different scenario, and I include a scrap from A Wall Street Journal piece dated December 12:

> But Mr. Kaufman continues to expect higher interest rates next year, when he anticipates renewed economic vigor. Addressing a meeting of about 1,200 clients of Salomon Brothers, he predicted that the federal funds rate will climb back up to the 10½%-to-11% range during the third quarter next year.
>
> Treasury bond yields are likely to surge to about 13% to 13½% during that period, according to a 44-page report issued by Mr. Kaufman, and two other Salomon Brothers analysts, James McKeon, vice president, and Nancy Kimelman, financial markets economist..

In a further Salomon Bros. comment, R.S. Salomon Jr., writes: "Over the next 12 months we expect the S & P to provide a total return of about 25%. This projection is based on our forecast of a reacceleration in corporate profits in the first half of next year and our belief that at current levels the market is undervaluing the outlook for the quality of earnings."

Now here's another fascinating piece of market sentiment from Ned Davis's *Business Timing Guide.* Here we see the consumer sentiment statistics compiled by the University of Michigan. So



not only are the investment advisors extremely bullish but the American consumer is more bullish than any time in the last 19 years.

Will the consumers and the investment advisors be right? I don't know, but it is worth noting that the last time consumers were this optimistic was back in 1965, just months prior to the famous bull market peak of February, 1966.

TRUTH, QUESTIONS: A few months ago I wrote that if EVERYBODY (you, me, the politicians, Mr. Reagan, your kids, the Russians, the Chinese, the Brazilians) insisted on the TRUTH, then all the world's problems would be solved. I am firmly convinced of the validity of that statement. Of course, it's not happening. Mr. Reagan tells us he won't raise taxes, but you and I know that when the chips are down Senator Dole will raise taxes, and Reagan will say that it's all in the interest of fairness. And you and I know that the Russians may say they want peace, but what they really want is the triumph of Communism, worldwide. So if saying they want peace helps in their master plan, fine. The Russians want peace.

All right, enough of that. Suffice it to say that I believe most of the world lives by lies, half-truths, deceits, white lies, exaggerations. People tend to say whatever they think will get them ahead or whatever they think other people want to hear or are entitled to hear.

Is insisting on the truth dangerous? It can be. If you insist on telling the truth in Russia, you end up at hard labor. If you insist on the truth in South Africa, you probably get your jaw broken by a police bludgeon.

But I firmly believe you can tell the truth in the US, and that's where 80% of my subscribers live. I believe that if Americans insisted on the truth this nation would be much stronger, much more solid, much more of an example to the rest of the world.

The funny thing is that almost everyone knows the truth when they hear it. They may hate it, they may want to kill you for it, they may not talk to you if you insist on the truth. But I think the truth is worth whatever you have to suffer for it, at least in the US (I'm not asking you to die for the truth, I'm not asking you to stand on a street corner in Cape Town and preach equality. That's asking too much – at present).

Truth usually ends when the person faces any kind of penalty for speaking the truth. If an advisor lives by hard money, then he ignores the charts and continues to talk up gold – even though gold is sinking. If a man cheats on his wife, he tells her some nonsense because he doesn't want to go through the pain of taking responsibility for what he's done. So he lies by omission – he says nothing.

I'll stand on this statement: I've never seen the truth blow up anything that was worth keeping. The truth ultimately exerts a *curative action* on anything it touches. I think I know. For many years I told people what I thought they wanted to hear. But that's deceit and it's basically evil. Now I do everything out in the open, and I stand on everything I do. If someone doesn't like my life or my words, I'm sorry. My life and my words are ME, and that's all I offer.

A corollary of the truth is this: you must give yourself the *right to ask questions.* You have the right to question anybody at any time about anything. I gave myself that right many years ago. I have the right to ask anybody anything. They, of course, have the right to say, "I won't answer." And that kind of response tells me something too.

Most people are very *passive.* A girl meets a guy, she likes him, but she doesn't even have the nerve (she doesn't give herself the right) to ask him if he's married. A patient goes to a doctor and hasn't got the nerve to ask the doctor what his fees are. A waiter asks a diner how the meal was. The meal was rotten but the diner smiles and says, "It was fine." A client buys an insurance policy, and he doesn't ask the salesman what his credentials are. A mother hires a baby sitter, and she fails to ask the sitter who else she has sat for and she fails to check the sitter's credentials.

If you want to live by the truth you have to develop what I term a "healthy skepticism." Next you have to demand of yourself the right to ask questions of anyone. Finally, you have to demand of yourself that you be totally honest at all times.

All of which admittedly is not easy. But in my opinion, it's easier (and far healthier) than living a life of half truths, nonsense and lies. After all, the truth is reality. If we can't live by reality, then we're crazy, we're nuts. And with 44 different wars going on simultaneously, with $200 billion deficits in the US, with Africa starving, with 1000% inflation in Israel, with a majority of so-called civilized nations in the world still resorting to human torture, I can tell you the world is pretty nuts.

There is a very close connection between lying and insanity. Understand the full meaning of that statement, and you'll understand 95% of the world's problems and troubles.

After writing this piece, I noted a front page article in the December 20 WSJ about a sociopath (i.e. a man with no conscience) and con artist named Bernard Striar. Striar specialized in marrying sundry women, cheating businessmen and then disappearing. Two things stand out in the article: Striar depended on (1) people being undone by their own greed, (2) people never asking the right questions or never checking on Striar's accounts of himself.

NOTES & QUOTES: Help! A few years ago I saw a study on averaging up or averaging down in bonds. The study concluded that because of the compounding effect, it was ultimately more profitable to average down at progressively higher interest rates than it was to average up at progressively lower interest rates. As I remember, the study was based on action in a tax-deferred pension fund.

If any of my subscribers have this study or a comparable study or if any of my computer-genius subscribers would care to run off such a study I would be most grateful. The study could run some-

thing like this: what happens if one buys bonds that rise steadily from 10% to 20% in yield over a 20 year period (with equal purchases every six months). Compare that with a study where one buys bonds that decline steadily in yield from 10% to 5% over a 20 year period. Obviously, the rising-yield bonds will decline steadily in price while the declining-yield bonds will rise steadily in price. The study, of course, is absolutely fundamental to pension plan administrators and serious investors.

* *

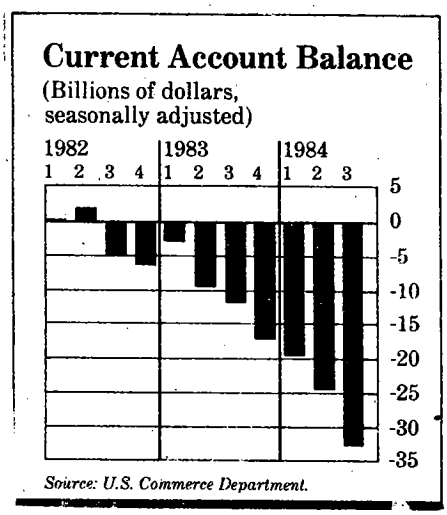
Interesting Statistics Dept: Is New York about to take over from Detroit as the "Murder Capital" of the nation? NYC now has 1500 murders a year or one every six hours!

LA is still the "Bank Hold-up" capital of the nation. One day a few weeks ago there were 18 bank hold-ups in LA (the record was 21 during one day in December, 1983).

More statistics: The enlisted part of the armed services is becoming more than just integrated. Now 31% of all enlisted men are black.

In the last two years salaries for NFL players have jumped 54%. With the squeeze on profits coming, more and more NFL teams are for sale (and the same is true of professional baseball teams).

Can the US exist by just selling software and hamburgers to itself? Who knows, but as far as heavy goods exports are concerned, we're dying. The current account balance includes everything including US trade, goods services, government transfers. For the third quarter our current account balance was a negative $32.9 billion, a record. Here's what a quarterly chart looks like. Will foreigners own the US some day? They will if this trend continues.



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Senator Barry Goldwater of Arizona is going to be the new Chairman of the Senate Armed Services Committee. Barry doesn't mince words, and he's already said, "Cancel the MX" (which our government has already spent $8 billion on). Here are a few choice words from Barry's own mouth, as seen in the Washington Post:

> The panel agreed last year to reexamine the oft-studied issue of Pentagon reorganization. Goldwater said he believes that change is needed in the way the Defense Department operates, but said he does not know what form it should take.
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> "It's the whole goddamn Pentagon," he said. "I don't think it should take 22,000 people to run the whole hierarchy of the military."
>
> "Why it takes so goddamn many men to sum up the thinking and discussion of four men who meet maybe three times a week, I don't know," he said. "But there's too many good military men tied up in the Pentagon who ought to get their asses out and go back out in the field."
>
> Goldwater said he strongly supports continued CIA aid to the "contra" rebels in Nicaragua but believes that Congress will not approve such aid. He said he believes that the administration is following a wise course in Central America.
>
> Goldwater restated his belief that the United States has "lost the last two wars" in Korea and Vietnam because of civilian interference in the military conduct of those wars. Future wars, he said, should be left to military officers who know how to fight.
>
> While saying he does not necessarily support reform of the Joint Chiefs of Staff—often cited as too weak to curb costly rivalries among the Army, Navy, Air Force and Marines—Goldwater said that the joint staff is too large.

* *

Do federal agencies take on a life of their own (like cancer)? My feeling is that they do, as witness this squib from the WSJ:

> WASHINGTON—Ronald Reagan became president four years ago on a platform calling for an end to the Education Department. Within months he had pushed through cuts of $1.35 billion in the department's budget, but today the department is getting $3.4 billion more in appropriations than Jimmy Carter was spending.

* *

Budget: By all accounts, the military and the Social Security budgets are sacred. But those two plus interest on the federal debt are the big spending items. If the boys in Washington want to really cut the budget, then they will have to hit the military and Social Security. Would they dare? I think they'll have to. Below are two paragraphs I clipped from last week's newspapers:

> WASHINGTON—New Senate Majority Leader Robert J. Dole predicted Monday that Congress ultimately will pass a deficit reduction package, including cuts in both Social Security benefits and defense spending—two items that have been considered off limits by President Reagan.
>
> **"There's a feeling of desperation," one congressional staff member involved in the budget process said. "We can't wait for Reagan's budget to go down in flames before trying to get another one off the ground. That would be too late."**
>
> **The GOP leaders, under incoming Senate Majority Leader Robert J. Dole of Kansas and Budget Committee Chairman Pete V. Domenici of New Mexico, have settled on a proposal to impose an across-the-board freeze on the budget for 1986 as the quickest and fairest way to reduce growing federal deficits.**

* *

The new disinflation (which began in 1980) is beginning to hit. For instance, John De Lorean's 48-acre San Diego estate was on the market three years ago for $4-5 million. Then the price dropped to $3.7 million early this year. The property has just been relisted for $2.7 million, down another million. Who's the new seller? Howard Weitzman, the defense lawyer who took the title as payment for his defense of De Lorean. Is it true – in the end do the lawyers get everything?

Speaking of lawyers, can you believe what's happening in India? A parade of big-time US attorneys have arrived in India, many of them walking the streets trying to sign up class action clients for $15 and $20 billion suits against Union Carbide. To me, it's disgusting and the worst possible advertisement for US lawyers.

I would guess that subscribers wonder why I write notes and whether I ever receive any complaints, answers or feed-back from these sundry comments. The answers are (1) I write the notes and quotes because I enjoy writing them, and because many subscribers (and their wives and children) seem to enjoy them as much as the market material. (2) I very often receive comments regarding the notes. Very frequently, for instance, if I mention a book the author will write me a thank-you note or if I suggest a product the manufacturer or a customer will write.

Examples: I recommended (very highly) the Kloss Novabeam TV. This extraordinary TV projection system is bar-none, the BEST in the field – and it has been a constant pleasure for me. The Kloss needs a room of its own, it throws its bright image on a six-foot screen. If you do have the room, I cannot recommend the Novabeam too highly. I probably received two dozen requests for more information on the Kloss from subscribers. My recommendation – you won't be sorry.

I complained about the dining service at the lovely and fashionable Beverly Hills Bel-Air Hotel some months ago. Last week the managing director wrote me a sympathetic apology note, and I am hereby invited to try another meal "on the house" (which I will do).

Last week I received a note from the chairman of the board of Winn-Dixie Stores, and the chairman was kind enough to enclose a copy of the inter-company memorandum in which I was quoted. The memorandum noted that Winn-Dixie supported the organization called Citizens Against Waste. As you know, our government wastes billions of dollars, so if I can contribute anything to help halt this great shame, I'm happy to do it (believe me, I'm more than happy, I'm delirious!).

New Orleans: I just got a nice letter from my old friend, Jim Blanchard, inviting me to be a featured speaker at the 12th Conference down in New Orleans in November 1985. Jim notes that I've been one of the few hard money advisors who has been right on gold. So I'm planning way ahead, and I'll be there. Besides enjoying the big seminar and seeing hundreds of old friends, there's a certain restaurant down in New Orleans that I plan to invade each and every night. It's called K-Paul's and it's run by a very large (400 pounds) Paul Prudhomme, a chef-genius. Paul is a creator and master of Cajun food, and over the last few years he's become famous. Why is he famous? Next time you're down in New Orleans stop in at his restaurant – and you'll know why after your first dinner. The food isn't just an experience, it's a revelation!

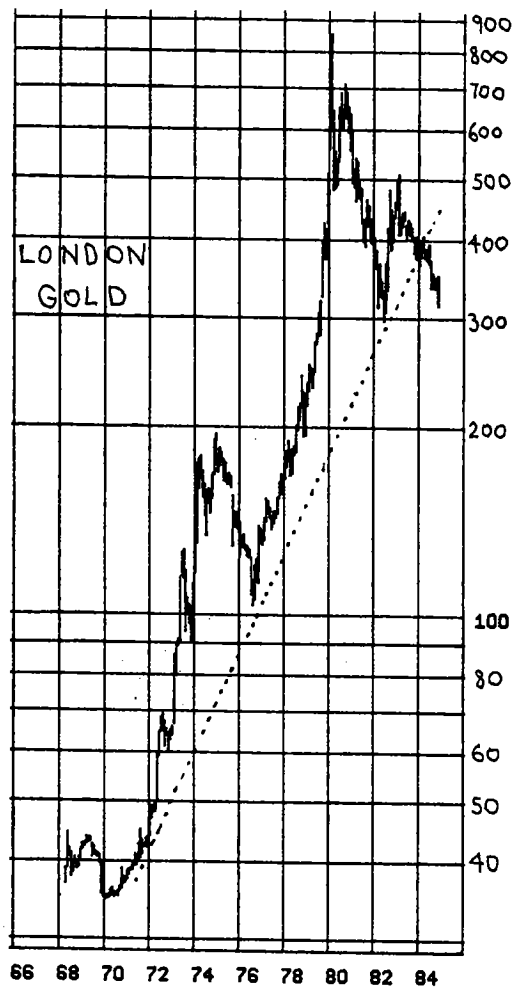
GOLD: I've been saying that the T-bond chart is the most important chart on Wall Street. Revise that statement – maybe the gold chart is. Here's a monthly ratio chart tracing gold from its 1970 price of 35 up to its 1980 bull market peak of 850. What we see here is a classic "stilt formation" that is in the process of breaking down. At last week's price of 308, gold had lost 63% of its 1980 high market value. The next support level on gold is obvious – it's the 295 low of 1982. If that low is broken, there is no real support down to 200.

I am aware that most people view gold as just another commodity like tin or wheat. If that's what you think – forget it. Gold is (1) real money, and (2) it is our most sensitive gauge of inflation or deflation. If you understand this, you will realize the extreme importance of this chart.

I feel that the bear market in gold is ominous – and it is deflationary. What are the odds, you ask, of a real deflation (depression) setting in during 1985 and beyond? I don't know – nor does anyone else. On the one hand, the odds are always against disaster (which is what deflation would be at this point). On the other hand, gold is the most sensitive of all inflation/deflation items, and gold is sinking, sinking, sinking.

What would deflation mean if it hit during the coming years? I will give you this extreme example: suppose you owed $50,000 in 1929. Times were good and you would probably say, "So what!" Now let's move out two years. It's 1931 and the economy is crumbling. That $50,000 now looks like $5 million. Deflation and hard times makes debt look like a financial frankenstein.

And that's what worries me about gold going down the way it is. If the gold bear market is spelling deflation, then this nation is in trouble. It's estimated that there is at least $5 trillion in debt in America (debt of all kinds), and my feeling is that if this economy deflates, the debt will be almost impossible to manage. The first reaction to real deflation could be a shock that nobody expects, and that is a panic for cash and liquidity. Such a panic could send interest rates through the roof, at least temporarily.



LATE NOTES: It's incredible the way the PTI seems to cling to that moving average. Watch the daily high-low statistics for hints as to the next direction of the market (the highs are now surpassing the lows for the first time since late November). If the market again switches to more daily lows than highs, then I'd say it's headed down. Otherwise, it would seem that the year-end rally has further to go. The economists with rare exceptions are now talking about 2 to 4 percent GNP growth next year. You can bet it will be a lot more or a lot less.

NEXT MAILING: Jan. 9